Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Leach | Analyst: Roger Lackey | Bill Number: AB 831

Related Bills: None | Telephone: 845-3627 | Introduced Date: 02-24-99

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Limited Liability Companies Permitted To Have One Member

SUMMARY

This bill would authorize the organization of single-member limited liability companies (LLCs) in California.

EFFECTIVE DATE

This bill would be effective January 1, 2000.

Program/Background

The Beverly-Killea Limited Liability Company Act (1994) authorized the creation of limited liability companies (LLCs). An LLC is a hybrid unincorporated business association entity, having two or more members, which affords its members:

- limited liability, with the extent of a member's liability limited to equity investment;
- flexible management alternatives; and
- liberal membership qualification requirements.

LLCs combine traditional corporate and partnership characteristics and resemble forms of limited liability organizations that have been well known and widely used in Europe and South America. Members of an LLC are afforded the same advantage of limited liability as are shareholders of a corporation while usually being subject to only one level of income tax as are the limited partners of a limited partnership, but allow LLC members to participate in the management of the LLC. LLCs lack the membership restrictions imposed on S corporations.

SPECIFIC FINDINGS

Under **federal** law, a business entity is classified as either a “corporation per se,” treated and taxed as a corporation, or an “eligible entity” entitled to elect its classification as follows:

- If the eligible entity has only one member, it will be disregarded as an entity separate from its owner unless it elects to be treated as a corporation; or
- If the eligible entity has two or more members, it will be taxed as a partnership unless it elects to be classified and taxed as a corporation.

Board Position:

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Department Director: **Gerald Goldberg** Date: **3/25/1999**

Any “eligible entity” that fails to make a proper election will be classified according to default classification rules:

1. with regard to domestic entities, an eligible entity with a single owner is disregarded as a separate entity;
2. an eligible domestic entity with two or more owners is classified as a partnership;
3. with regard to foreign entities, an eligible entity with a single owner is disregarded if its single owner does not have limited liability;
4. a foreign entity in which all members have limited liability is classified as a corporation; and
5. a foreign eligible entity with two or more owners is classified as a partnership if at least one member does not have limited liability.

Thus, for **federal** purposes, a corporate-owned, single-member LLC that files a federal form 966 is disregarded and, for tax purposes, effectively disappears and is treated as a division or branch of its corporate parent. An individually owned single-member LLC that is disregarded is treated as a sole proprietorship.

Existing state law authorizes the creation of a California LLC and the registration in California of LLCs created under the laws of other states. The tax treatment of an LLC under existing state law depends on its classification for tax purposes.

In general, if an LLC has more than one owner (known as “member”), it is classified as a partnership for federal and state tax purposes unless it elects to be classified as a corporation. If an LLC has a single member, its existence as an entity separate from its owner will be disregarded for federal and state tax purposes unless it elects to be classified as a corporation.

Currently, a single member LLC may not organize in California, but such an entity that organizes in another state which does permit single member LLCs may register to do business and operate in California.

Under **existing state law,** an LLC classified as a corporation for federal and state tax purposes is subject to the corporation franchise tax, including the minimum franchise tax, and the corporation income tax like any other corporation. As a result, an LLC classified as a corporation that is organized in this state or registered with the Secretary of State (SOS) is required to prepay the corporate minimum franchise tax to the SOS at the time of organization or registration.

E**xisting state law** provides that every LLC not classified as a corporation (i.e., classified as a partnership or disregarded) that is organized in this state, registered in this state, or doing business in this state shall be subject to an annual tax in an amount equal to the minimum franchise tax until the effective date of cancellation or, if later, the date the entity ceases to do business within the state.

Existing state law provides that a LLC not classified as a corporation also shall pay an annual fee based on the total income from all sources reportable to this state for the taxable year. For example, an LLC with total income for the taxable year greater than $250,000, but less than $500,000, the fee would be equal to $500.

As the total income for the year increases, so does the fee to a maximum amount of $4,500 based on a total income that exceeds $5 million.

The annual fee payable by LLCs is required to be adjusted annually for taxable years beginning on or after January 1, 1999.

This bill would authorize the organization of a single-member LLC in California.

Policy Considerations

The tax policy regarding the tax treatment of a single-member LLC that is not classified as a corporation was resolved for foreign LLCs by the enactment of earlier legislation requiring the Franchise Tax Board to issue regulations substantially similar to federal regulations regarding the classification of business entities. This bill would allow single-member LLCs to organize in California, allowing domestic LLCs similar treatment granted to foreign LLCs.

Implementation Considerations

This bill would not significantly impact the department.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The net revenue impact of expanding the Beverly-Killea Limited Liability Company Act to single-member entities is not known.

Even though current law requires annual recalculations of the LLC fee amounts to produce revenue neutrality overall, it is not known what impact the current fee structure or subsequent recalculations would have on single-member LLCs only. Net revenue gains, losses, or neutrality could result in any given year.

BOARD POSITION

Pending.